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# Notice 2023-80: When the U.S. Tax Code Meets Pillar Two

John Barlow, Rafic H. Barrage, Ethan Kroll, Sam Pollack, and Steven Smith*
Baker McKenzie LLP

*Notice 2023-80 illustrates the challenges of reconciling Pillar Two and the U.S. federal regime for the taxation of international income, state John Barlow, Rafic Barrage, Ethan Kroll, Sam Pollack, and Steven Smith of Baker McKenzie.*

On December 11, Treasury and the IRS issued Notice 2023-80 (the "Notice"), which represents the U.S. government's first attempt to address the U.S. federal income tax implications of Pillar Two. The Notice provides guidance on the foreign tax credit and dual consolidated loss ("DCL") issues that arise from certain Pillar Two taxes.

The Notice provides guidance on five main topics. First, the Notice confirms that it is possible for a Qualified Domestic Minimum Top-up Tax ("QDMTT") and a tax under an Income Inclusion Rule ("IIR") to qualify as a creditable "foreign income tax" under Treas. Reg. §1.901-2. However, the Notice does not provide a blanket safe harbor for these taxes and instead requires taxpayers to determine whether any particular QDMTT or IIR meets the various regulatory requirements for creditability. Second, if the taxpayer determines that an IIR tax is a foreign income tax, the Notice proposes to generally disallow a foreign tax credit for that tax. Third, the Notice proposes guidance on how to allocate QDMTTs among entities within a jurisdiction for foreign tax credit purposes. Fourth, the Notice confirms that Treasury and the IRS may interpret the jurisdictional blending rules of Pillar Two as giving rise to a disallowance of deductions under the DCL regime and trigger the recapture of DCLs for which taxpayers previously made domestic use elections. Fifth, the Notice extends the period of relief from the application of the 2021 final foreign tax credit regulations until Treasury and the IRS provide another notice or further guidance.

*John Barlow and Rafic H. Barrage are partners in Baker McKenzie LLP's Washington, D.C. office. Ethan Kroll is a partner and Steven Smith is an associate in the Los Angeles office. Sam Pollack is a partner in the Chicago office.

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We focus this article on the Pillar Two aspects of the Notice, and not on the extension of relief from the application of the final foreign tax credit regulations, given the novelty of the interaction between Pillar Two and U.S. federal income tax.

## IIRs and the U.S. Foreign Tax Credit Provisions

The Notice's guidance on IIR taxes is the Notice's most controversial and intriguing aspect. The Notice first acknowledges that a country's IIR tax can potentially qualify as a creditable foreign tax under §901 (i.e., a "foreign income tax" in the language of Treas. Reg. §1.901-2) depending on how a country enacts its IIR tax. This acknowledgment is helpful, as there was some uncertainty as to whether any IIR tax could satisfy the various requirements of the 2021 final foreign tax credit regulations (although some taxpayers already believed that CFC tax regimes like the IIR could be creditable).

It would be interesting to understand Treasury and the IRS's specific reasoning for concluding that an IIR tax could be a creditable foreign income tax—especially given that Treasury and the IRS have suspended the latest incarnation of the foreign tax credit regulations. In the meantime, taxpayers will be required to analyze the creditability of each country's IIR (and QDMTT) regime based on either the 2021 final foreign tax credit regulations or, if the taxpayer relies on the relief provided under Notices 2023-55 and 2023-80, under the prior foreign tax credit regulations. Moreover, Treasury and the IRS have stated that they will not provide definitive guidance on whether any Pillar Two tax is a foreign income tax because (1) the IRS has a no-rule policy for whether a tax is a foreign income tax under Treas. Reg. §1.901-2, and (2) countries can deviate from the Pillar Two Model Rules when implementing any of the Pillar Two taxes.

Having helpfully acknowledged that IIR taxes may be creditable, the Notice then proposes to add a completely new, non-statutory credit disallowance rule. Under this new rule, a credit is disallowed for an IIR with respect to a person "if, under the foreign tax law, any amount of United States federal income tax liability of the person would be taken into account in computing the [IIR tax]" (the "Push-Down Disallowance Rule") (*See* Notice §2.02(3)). In addition, if a particular IIR tax qualifies as a foreign income tax but is disallowed as a credit under the Push-Down Disallowance Rule, the Notice also proposes to cause a U.S. shareholder to recognize a §78 gross-up for that disallowed IIR tax (if owed by its CFC) and to deny a U.S. person a deduction under §275(a)(4) for that IIR tax (if treated as paid directly by a U.S. person) (*See* Notice §2.02(5)). Given guidance in the Commentary to the Pillar Two Model Rules, taxpayers had steeled themselves for Treasury and the IRS to disallow a foreign tax credit with respect to IIR taxes. However, few, if any, taxpayers expected an income inclusion and denial of a deduction to accompany that disallowance.

**The Push-Down Disallowance Rule.** As indicated above, the Push-Down Disallowance Rule is in §2.02(3) of the Notice, which provides: "No credit is allowed under §901 or §59(l) to a person for a final top-up tax if, under the foreign tax law, any amount of United States federal income tax liability of the person would be taken into account in computing the final top-up tax." The Notice then defines a "final top-up tax" as a foreign income tax, if, in computing that foreign tax, "the foreign tax law takes into account (a) the amount of tax imposed on the direct or indirect owners of the entity subject to the tested tax by other countries (including the United States) with respect to the income subject to the tested tax, or (b) in the case of an entity subject to the tested tax on income attributable to its branch in the foreign country imposing the tested tax, the amount of tax imposed on the entity by its country of residence with respect to such income" (*See* Notice §2.02(2)).

The basis for the definition of a final top-up tax likely lies in Article 4.3.2(c) of the Pillar Two Model Rules, which provides that taxes that a direct or indirect shareholder pays on income of a Constituent Entity (such term as defined in the Pillar Two Model Rules) can be treated as Covered Taxes for purposes of computing the Pillar Two liability with respect to that Constituent Entity. An IIR that follows the Pillar Two Model Rules will therefore generally impose tax on the difference between (1) the 15% minimum tax rate on income in a given jurisdiction, and (2) the taxpayer's effective tax rate in that jurisdiction, taking into account direct or indirect shareholder jurisdiction taxes imposed with respect to Constituent Entities in that jurisdiction. As a foreign income tax constitutes a final top-up tax if shareholder tax with respect to income that is subject to the foreign income tax is taken into account, an IIR under the Pillar Two Model Rules therefore generally qualifies as a final top-up tax.

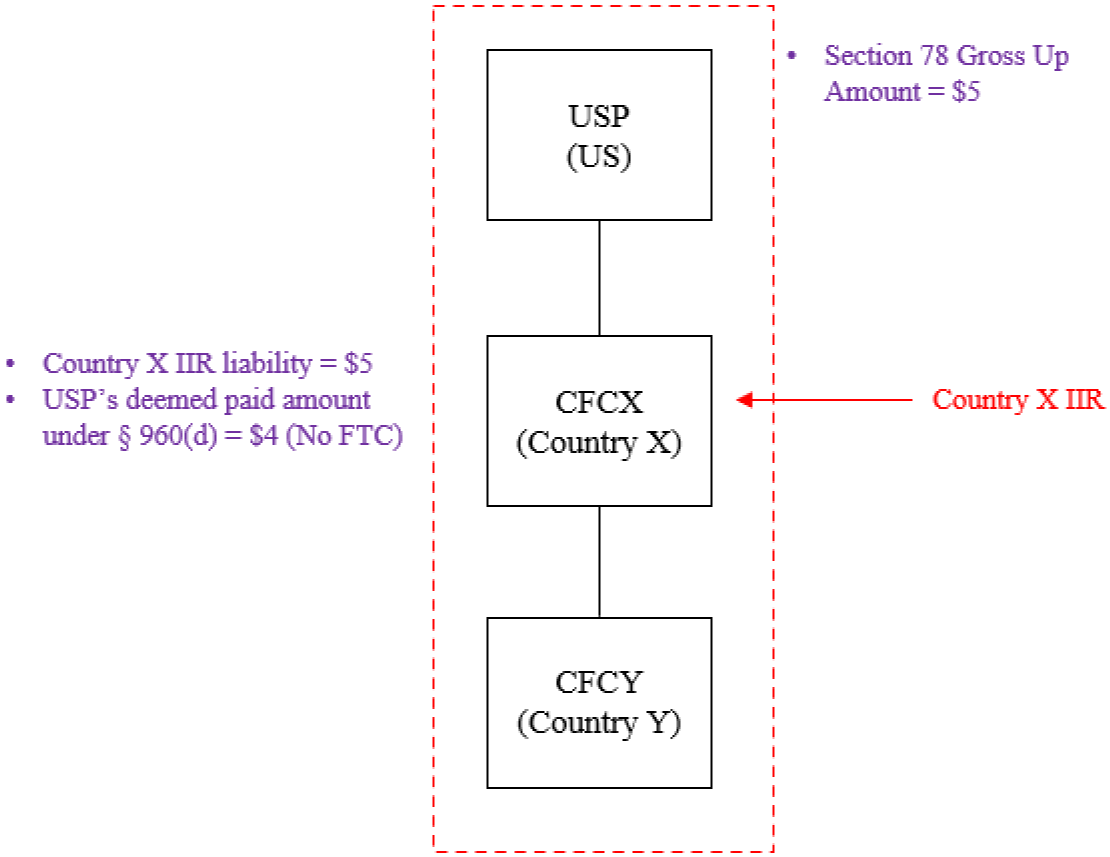
An IIR tax qualifies as a final top-up tax if the IIR simply looks to the tax paid by any shareholder or branch owner, regardless of whether the shareholder/branch owner is a U.S. person. However, unlike the final top-up tax definition, the Push-Down Disallowance Rule only applies if the IIR tax is actually determined by reference to the taxes paid by a U.S. shareholder or branch owner (regardless of whether any tax is paid by the shareholder or branch owner). This distinction is especially important when it comes to minority shareholders, as will be explained further below.

To reiterate, the fact there may not be any actual U.S. federal income tax liability under the GILTI, subpart F, or CAMT regimes does not mean that the Push-Down Disallowance Rule does not apply and an IIR is creditable. For purposes of the Notice, the fact that some U.S. federal income tax liability could in theory be taken into account as part of the IIR tax computation is sufficient for the Push-Down Disallowance Rule to apply.

To sum it all up, for the Push-Down Disallowance Rule to apply to an IIR: (1) the IIR must qualify as a foreign income tax under Treas. Reg. §1.901-2, (2) the IIR must qualify as a final top-up tax under §2.02(2) of the Notice, and (3) an amount of U.S. federal income tax liability of a direct or indirect shareholder must be taken into account in computing the IIR tax owed (regardless of whether there is in fact any U.S. federal income tax liability that is taken into account in the computation).

The Notice includes the following example that illustrates the operation of the Push-Down Disallowance Rule.

# Example 1 – IIR that is a foreign income tax




In Example 1, Country X imposes an IIR that subjects CFCX to tax on the income of CFCY. Under its IIR, the foreign tax liability of the direct and indirect owners of the Country X taxpayers that relate to the income subject to the IIR is taken into account if those owners are part of the same MNE Group (as defined under Country X's tax law) as the Country X taxpayer. Assume that the Country X IIR qualifies as a foreign income tax under Treas. Reg. §1.901-2. Based on these facts, the Country X IIR is a final top-up tax.

Assume that USP, CFCX, and CFCY are all members of the same MNE Group under Country X tax law. For 2024, further assume that CFCX is liable for $5 of the Country X IIR on CFCY's income, and USP is deemed to pay $4 of the Country X IIR under §960(d). The $4 of Country X IIR that USP is deemed to pay is not eligible for a foreign tax credit under the Push-Down Disallowance Rule because, under Country X tax law, USP's U.S. federal income tax liability may be taken into account in computing the Country X IIR. This credit would be disallowed regardless of whether USP actually has any amount of U.S. federal income tax liability or whether any of that liability is, in fact, taken into account for purposes of computing the Country X IIR In addition, even though USP is denied a foreign tax credit, it must still recognize a §78 gross-up amount of $5.

**Section 78 Gross-Up and §275(a)(4) Disallowance for Credits Subject to the Push-Down Disallowance Rule.** If the Push-Down Disallowance Rule applies to an IIR tax, then, as noted above, the Notice proposes to make that tax subject to a §78 gross-up or a §275(a)(4) deduction disallowance (*See* Notice §2.02(5)). A CFC is nevertheless presumably still able to deduct its IIR taxes (except for purposes of applying the high-tax exceptions in §954 and §951A) because a CFC cannot choose to take the benefits of §901.

After taxpayers have gotten over their dismay at being required to recognize a §78 gross-up and/or being subject to a §275(a)(4) disallowance while simultaneously being denied a foreign tax credit for the same IIR tax, taxpayers may ask the following two questions: (1) what authority is the Notice relying on to disallow a foreign tax credit for an IIR that qualifies as a foreign income tax under §901, and (2) why doesn't the Notice instead treat IIRs as taxes that are not foreign income taxes so that taxpayers can at least deduct the IIR taxes or forgo a §78 gross-up?

With respect to the first point, Treasury and IRS officials have stated that they are relying on the policy behind §901 for their authority to promulgate regulations disallowing a foreign tax credit for foreign taxes that are determined in part by the amount of U.S. CFC taxes that are imposed on foreign income. Specifically, they believe that the foreign tax credit statutory scheme is incompatible with and cannot accommodate a foreign tax that is calculated by reference to a U.S. parent's CFC taxes because these foreign taxes create circularity issues. In particular, if the United States were to provide a foreign tax credit for an IIR tax, the theory goes that the IIR tax would need to be recomputed after the United States provides a foreign tax credit for the IIR tax because the amount of the U.S. parent's GILTI push down taxes to Constituent Entities below the relevant IIR jurisdiction entities would have decreased (due to the additional foreign tax credit). This foreign tax credit adjustment would continue creating additional circular adjustments because the United States would then have to provide a foreign tax credit for the additional IIR taxes, which would again perpetuate the loop by causing the U.S. GILTI taxes to further decrease and the IIR taxes to increase again. Thus, as a policy matter, the Notice's position makes some sense and is in line with the Pillar Two guidance that attempts to stop such circularity issues (*See, e.g.*, Commentary to the Pillar Two Model Rules, Art. 4 ¶ 45).

This discussion leads to the second point: if a taxpayer is not permitted to credit an IIR tax, why do Treasury and the IRS propose to require a §78 gross up with respect to the IIR tax? Here, too, it appears that Treasury and the IRS may have been seeking to avoid a circularity problem that arises from the way that the February 2023 Administrative Guidance allocates GILTI taxes based on a CFC's *pre-tax* income (*See, e.g.*, Pillar Two February 2023 Administrative Guidance at 2.10.3, new ¶58.4). The additional circularity issue that arises from Pillar Two and the §78 gross-up is illustrated as follows:

Assume that USP, a U.S. corporation, owns CFC 1, and CFC 1 owns CFC 2. CFC 1 is a Country X entity, and Country X has an IIR, QDMTT, and an income tax of 15%. CFC 2 is a Country Y entity, and Country Y has no QDMTT or income tax. CFC 1 and CFC 2 each earn $100 of pre-tax income that is subject to GILTI.

Based on these facts, USP has $200 of tested income and §78 gross up, which is reduced to $100 of taxable income (taking into account the $100 §250 deduction). USP also has $12 of tested income tax taking into account the 20% haircut under §960(d). Thus, USP owes $9 of tax on its tested income (i.e., 21% of $100 minus the $12 FTC). Under the Blended CFC Tax Regime computation set forth in paragraph 2.10.3 of the Pillar Two February 2023 Administrative Guidance, $9 of USP's tax on GILTI is pushed down to compute the $6 of Country X IIR imposed on CFC 1 (i.e., 15% of $100 minus $9).

However, USP is then entitled to reduce its tested income by the $6 of additional IIR tax because U.S. tax law allows CFCs a deduction for the additional tax expense. If there were no §78 gross up for the additional $6 IIR tax, then USP's tested income and §78 gross up (from only the original $15 of CFC1 tax) is now $194. This results in USP having $97 of taxable income after the §250 deduction. Thus, USP no longer owes $9 of tax on its GILTI and instead owes $8.37 (i.e., 21% of $97 minus $12 FTC). As a result, only $8.37 of GILTI taxes would be pushed down rather than the original $9, and Country X would now impose $6.63 of IIR tax. The circle would continue again as USP's tested income would be $0.63 lower due to its CFC's deduction for the additional IIR tax, and USP would again owe even less GILTI tax. Thus, this example illustrates that, even if an IIR is not creditable, a circularity issue persists unless the IIR still triggers a §78 gross up.

Even though there may be policy justifications for the Push-Down Disallowance Rule (and the seemingly contradictory application of the §78 gross up), the Pillar Two Model Rules and the Commentary are not authority on which Treasury and the IRS can ordinarily rely in issuing regulations. Moreover, while the drafters of the Commentary may well have acknowledged concerns about circularity, Treasury and the IRS must still identify some form of statutory authority on which to base the disallowance of a foreign tax credit for IIR taxes, given that Treasury and the IRS did not conclude that these taxes are not foreign income taxes under the §901 regulations. Section 901 is filled with statutory provisions that disallow credits for otherwise creditable §901 foreign income taxes. However, none of these statutory disallowance provisions applies to IIR taxes.

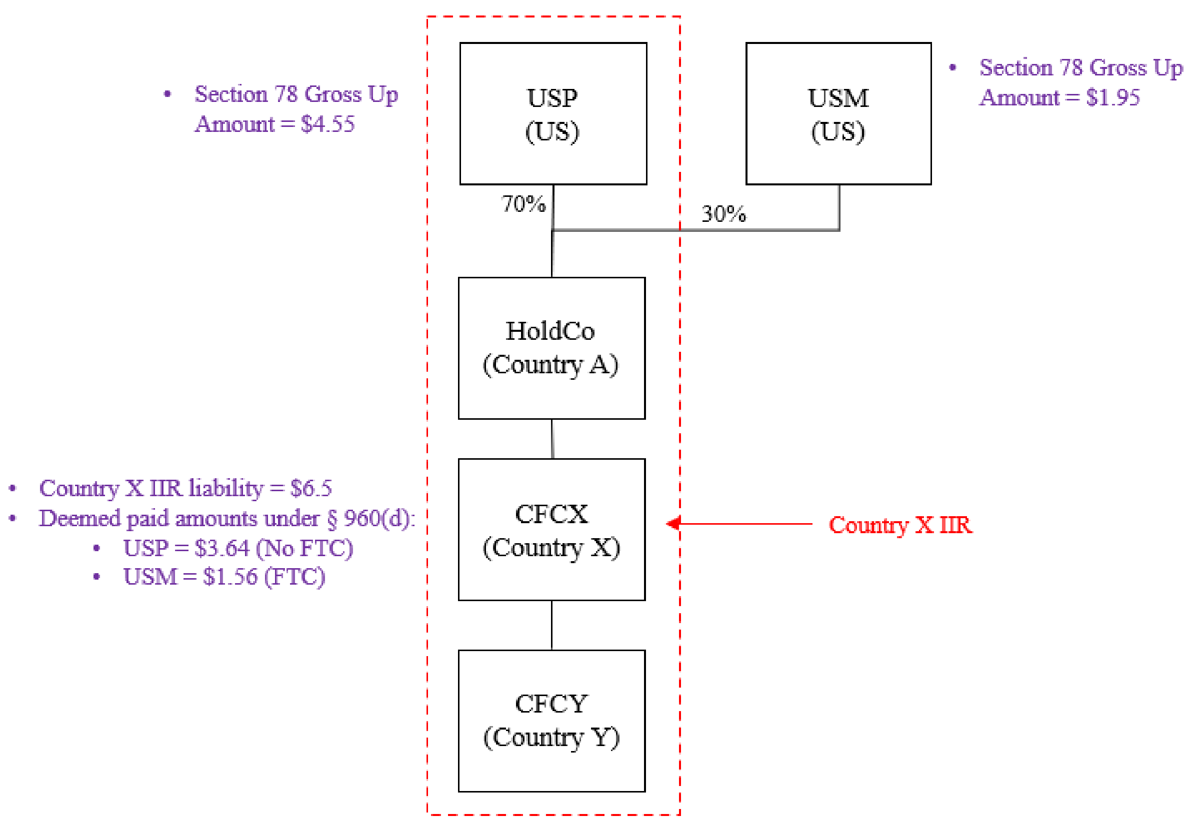
Rather than creating a non-statutory disallowance rule, Treasury and the IRS could have drafted a rule in the §901 regulations that defined a foreign income tax to exclude a final top-up tax. For example, the soak-up tax provisions in Treas. Reg. §1.901-2(e)(6) provide that the portion of a foreign tax that is dependent on the availability of a U.S. foreign tax credit is not a foreign income tax. Yet, the soak-up tax regulations do not disallow a credit for a tax that qualifies as a foreign income tax under §901; rather, they treat the "soak-up" portion of the foreign tax as an amount that does not qualify as a foreign income tax for purposes of §901.

Had Treasury and the IRS taken the position that IIR taxes are, like soak-up taxes, not foreign income taxes for purposes of §901, taxpayers could have avoided a §78 gross up or a §275(a)(4) deduction denial with respect to those taxes. Nevertheless, such a position would not have meshed with the OECD guidance that allocates CFC taxes based on pre-tax income in order to avoid circularity issues (*See, e.g.*, Pillar Two February 2023 Administrative Guidance at 2.10.3, new ¶58.4). It is also likely that Treasury and the IRS did not want to attempt an argument that an IIR tax that looks very much like a tax under the subpart F and GILTI regimes is not a tax on income at a time when the authority of the U.S. government to levy tax is in question – e.g., in connection with the Supreme Court's review of *Moore v. United States*, No. 22-800 (U.S.), 36 F.4th 930 (9th Cir. 2022), *cert. granted*, 143 S. Ct. 2656 (2023).

To be clear, we are not suggesting that IIR taxes are not foreign income taxes. We generally believe they are. And while majority shareholders of CFCs lose out under the Notice, as the following example makes clear, minority shareholders may still credit IIR taxes because IIR taxes are not calculated by reference to CFC taxes that a minority shareholder pays (*See* Pillar Two Model Rules, Commentary Art. 4 ¶ 58 (referencing the push down of taxes of Constituent Entity-owners in respect of CFCs); Pillar Two Model Rules, Art. 10.1.1 (defining a Constituent Entity-owner as "a Constituent Entity that directly or indirectly owns an Ownership Interest in another Constituent Entity of the same MNE Group.")).

The Notice includes an example to show how an IIR is treated in the context of a minority investment.

**Example 2 – Minority U.S. shareholder**



The tax analyzed in Example 2 is the same as the tax analyzed in Example 1. USP, but not USM, is considered to be a part of the same MNE Group as CFCX. For the same reason as in Example 1, the amount that USP is deemed to pay of the Country X IIR under §960(d) is disallowed under the Push-Down Disallowance Rule. In contrast, USM may be able to credit the amount that it is deemed to pay of the Country X IIR under §960(d) because USM is not part of the same MNE Group as CFCX (and USP). Because USM is not part of the MNE Group, Country X's IIR provisions do not allow any amount of USM's U.S. federal income tax liability to be taken into account in computing the Country X IIR tax. Thus, the Push-Down Disallowance Rule does not apply to USM's portion of the CFCX IIR tax, and USM (but not USP) is allowed a foreign tax credit for its portion of the Country X IIR taxes. As was the case for Example 1 above, USP and USM must include their pro rata share of the CFCX IIR liability in their respective incomes under §78 and Treas. Reg. §1.78-1(a) even though USP is denied a foreign tax credit.

Thus, as the above example shows, while the example's IIR is a final top-up tax with respect to the majority and minority shareholders, the Push-Down Disallowance Rule does not apply to the minority investor (USM) because the IIR does not look to the minority investor for purposes of pushing down taxes to the CFC.

Interestingly, certain statutory provisions that disallow foreign tax credits for otherwise creditable foreign taxes, such as §901(j), (k), and (m), expressly provide that §78 and §275(a)(4) do not apply to the taxes in question. Contrast these provisions with §78 itself (the second parenthetical thereof), which requires a gross-up for the full amount of foreign taxes imposed on GILTI, notwithstanding the 20% haircut on such taxes required by §960(d). A logical inference from these provisions is that only Congress has the authority to disallow foreign income taxes precisely because only Congress has the authority to turn off statutory provisions such as §78 and §275(a)(4). There is a clear symmetry in providing that a disallowed tax that otherwise qualifies as a foreign income tax under §901 is also not a foreign income tax for purposes of §78 and §275(a)(4). That Treasury and the IRS have gone so far as to deny a foreign tax credit for a foreign income tax in the form of an IIR tax, yet appear to be uncomfortable with also stating that §78 and §275(a)(4) do not apply to this tax, seems to indicate weakness in their position under the first step of the *Chevron* analysis. Alternatively, if Treasury and the IRS actually intended to deny a section 901 foreign tax credit and to require a §78 gross-up (and §275(a)(4) disallowance) to comply with OECD guidance, then it will be interesting to see whether the courts agree that Treasury has the regulatory discretion to disallow credits and require income inclusions in the absence of statutory authority.

We believe this quandary highlights one of the challenges that the U.S. government faces in relation to Pillar Two. It seems clear that Treasury and the IRS want to follow the direction of the drafters of the Commentary on the Pillar Two Model Rules and deny foreign tax credits for IIR taxes, but Congress has yet to tackle Pillar Two in a way that can allow Treasury and the IRS to do so. Simply put, while policy reasons may militate against providing a foreign tax credit for IIR taxes, these taxes look very much like foreign income taxes and are therefore likely creditable under current law.

## QDMTTs and the U.S. Foreign Tax Credit Provisions

As with IIR taxes, the Notice helpfully acknowledges that a QDMTT can qualify as a foreign income tax. The Notice does so in a third example – Example 3 – that appears in the context of the discussion of final top-up taxes (*See* Notice §2.02(6)(c)). The point of this example is to show how QDMTTs are not caught by the final top-up tax definition because the February 2023 Administrative Guidance generally allows QDMTTs priority in respect of shareholder taxes by providing that the CFC Push-Down Rule operates only after a QDMTT applies. Thus, in the words of the example, "the foreign tax liability of direct and indirect owners of the entity subject to the QDMTT is not taken into account" (*See* Notice §2.02(6)(c)(i)).

The Notice does not explain why or how a QDMTT can qualify as a foreign income tax, however, and therefore leaves open the question as to what criteria QDMTT regimes must possess for their QDMTTs to be creditable foreign taxes. Again, Treasury and the IRS have said that the Notice's silence was based on the fact that (1) the IRS has a no-rule policy for whether a tax is a foreign income tax under Treas. Reg. §1.901-2, and (2) countries can deviate from the model QDMTT rules when implementing a QDMTT.

Moreover, a tax that arises under a domestic minimum top-up tax that is not a QDMTT may suffer the same fate as IIR tax. For instance, several jurisdictions have considered implementing a QDMTT-substitute tax in which the jurisdiction will try to assert the authority to tax in priority to another country's IIR or UTPR regime while also sidestepping the February 2023 Administrative Guidance by allowing CFC taxes to constitute Covered Taxes.

The Notice nevertheless recognizes that many QDMTTs will likely be creditable and therefore helpfully provides additional guidance to ensure the current foreign tax credit framework continues to function appropriately once taxpayers start claiming foreign tax credits for QDMTTs. Specifically, the Notice proposes to clarify how QDMTT taxes are allocated among multiple entities in a jurisdiction for purposes of the foreign tax credit rules (*See* Notice §2.04).

Treasury and the IRS appear to believe that additional rules are needed for allocating QDMTTs among multiple foreign entities for purposes of determining which entity is the technical taxpayer with respect to its portion of the QDMTT. QDMTT is not imposed on a specific entity. Rather, QDMTTs are imposed on all of a group's entities that are resident in the same tax jurisdiction. Treas. Reg. §1.901-2(f)(3) is designed to allocate foreign tax between entities in such a scenario. However, Treas. Reg. §1.901-2(f)(3), arguably, would not provide appropriate results because it does not take into account a circumstance in which the various entities are subject to different rates of tax. Thus, the Notice provides rules for allocating a foreign income tax that takes into account not only the separate foreign income of the entities subject to QDMTT, but also the different rates at which the income of the different entities is taxed.

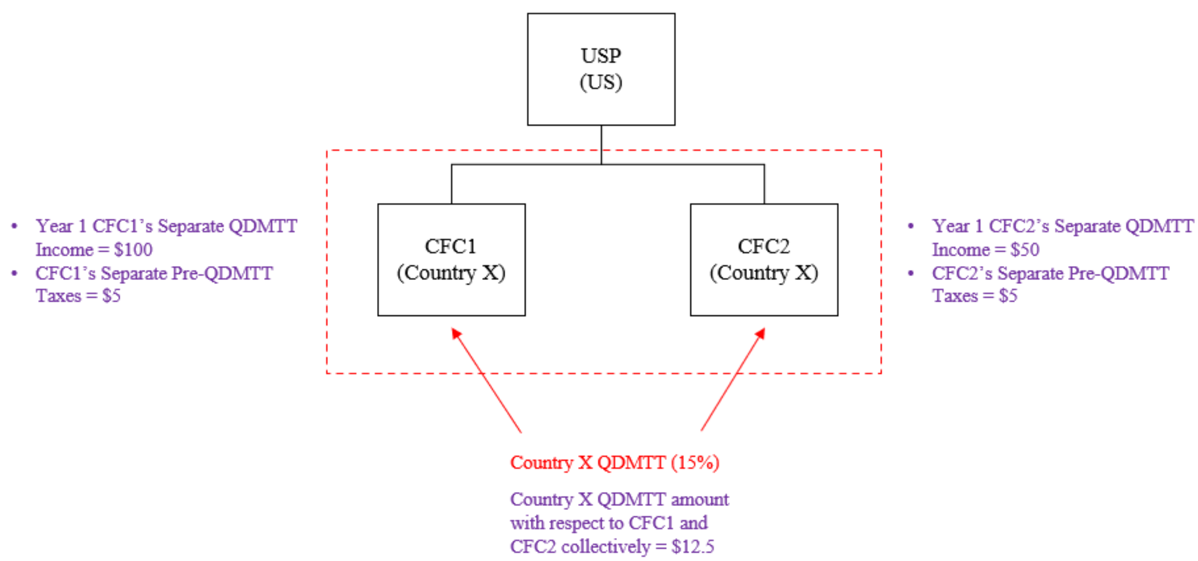
Specifically, §2.04(2) states:

"If a QDMTT is computed by reference to the income of two or more persons, foreign tax law is considered to impose legal liability for the QDMTT on each person in proportion to the person's QDMTT Allocation Key, as determined under this section 2.04(2). A person's QDMTT Allocation Key is the product of (i) the excess (if any) of the QDMTT Rate over the person's Separate Pre-QDMTT ETR, and (ii) the person's Separate QDMTT Income[.]"

The Notice provides more elaborate definitions, but the gist of the Allocation Key is that it is the product of the difference between the QDMTT minimum rate and a person's non-QDMTT ETR (the quotient of taxes taken into account in computing the QDMTT and the person's income for purposes of the QDMTT regime) and the person's income for purposes of the QDMTT regime. For purposes of the allocation rule, persons include individuals and entities (including disregarded entities) that are subject to a QDMTT regime.

The Notice includes the following example, which we label Example 4, to illustrate the operation of this allocation rule:

**Example 4 – QDMTT imposed on two or more persons**




In Example 4, Country X's QDMTT is imposed on entities that are resident in, or have a taxable presence in, Country X and that are members of the same MNE Group. Entities subject to the Country X QDMTT are jointly and severally liable for the QDMTT. The Country X QDMTT is computed with reference to CFC1 and CFC2's income, and the $12.5 of QDMTT liability is allocated between CFC1 and CFC in proportion to each entity's QDMTT Allocation Key. The QDMTT Allocation is the product of (1) the QDMTT Rate less the Separate Pre-QDMTT ETR, and (2) the Separate QDMTT Income amount. Here, CFC1 has Separate QDMTT Income of $100 and Separate Pre-QDMTT Taxes of $5. These facts mean that CFC1's income was subject to QDMTT at an effective rate of 5% ($5 tax / $100 income). Accordingly, CFC1's Allocation Key is (15% - ($5 / $100)) x $100) which equals $10. Thus, $10 of the $12.5 of QDMTT is allocable to CFC 1. CFC2 has Separate QDMTT Income of $50 and Separate Pre-QDMTT Taxes of $5. CFC 2 was subject to QDMTT at an effective rate of 10% ($5 tax / $50 income). Thus, CFC2's Allocation Key is (15% - ($5 / $50)) x $50) which equals $2.5. Thus, $2.5 of the $12.5 of QDMTT is allocable to CFC 1.

## Other Pillar Two and U.S. Foreign Tax Credit Considerations

The Notice also proposes to update the separate levy rules in Treas. Reg. §1.901-2(d) so that each of a QDMTT, IIR tax, and UTPR tax is treated as a separate levy (*See* Notice §2.03). This change allows a country's regular foreign income tax and some of the country's Pillar Two taxes to qualify as foreign income taxes under §901, even if one of a country's Pillar Two taxes (such as a UTPR) does not qualify as a foreign income tax under §901. This proposed change should give taxpayers comfort that any noncreditable Pillar Two taxes will not jeopardize the creditability of historic income tax regimes.

Finally, the Notice clarifies that withholding taxes and other in lieu of taxes under §903 will continue to be creditable once a country adopts Pillar Two. Specifically, the Notice provides that an in lieu of tax (e.g., a withholding tax) can still be creditable under §903 even though the in lieu of tax is only imposed in lieu of a country's general income tax and not in lieu of a country's Pillar Two taxes (*See* Notice §2.05). Without this change, some taxpayers had questioned whether in lieu of taxes were creditable if both the in lieu of tax and Pillar Two taxes (in particular UTPR taxes) could apply simultaneously to a taxpayer.

## Pillar Two and the DCL Rules

Section 3 of the Notice flags the anticipated interaction between Pillar Two and the DCL rules. DCL issues arise because it is not clear whether an expenditure that gives rise to a DCL and that also reduces tax under a QDMTT, IIR, or UTPR regime has been subject to (or should even be treated as giving rise to) "foreign use" as described below.

**Overview of a DCL.** Generally speaking, a DCL is a deductible expenditure (or group of deductible expenditures) attributable to the net operating losses (an "NOL") of a "separate unit" of a U.S. corporation (setting aside, for the purpose of this discussion, dual resident corporations) (*See* Treas. Reg. §1.1503(d)-1(b)(5)). A "separate unit" is either a foreign branch, a foreign disregarded entity, or an interest in a foreign partnership, in each case, owned by a U.S. corporation (*See* Treas. Reg. §1.1503(d)-1(b)(4)). The DCL rules determine whether the separate unit would have an NOL by allocating the items of income, gain, deduction, and loss of the separate unit's U.S. corporate owner to the separate unit (*See generally* Treas. Reg. §1.1503(d)-5(c)). When the separate unit is a disregarded entity, this exercise is generally relatively straightforward, as the regarded items reported on the books and records of the disregarded entity are the items allocated to the disregarded entity (*See* Treas. Reg. §1.1503(d)-5(c)(3)). To the extent the items allocated to a separate unit result in an NOL, the U.S. corporate owner's otherwise deductible amounts are treated as a DCL with respect to which a deduction is disallowed (*See* Treas. Reg. §1.1503(d)-4(b)).

DCL Example 1: USP, a U.S. corporation, owns a Country X disregarded entity ("DREX") and Country X controlled foreign corporation ("CFCX"). DREX and CFCX are part of a combined reporting group pursuant to which Country X allows loss sharing between DREX and CFCX. In Year 1, on a separate entity basis, USP has $100 net income, CFCX has $100 of net income, and DREX has a net loss of $100. Absent the DCL rules, USP would have no net income for U.S. tax purposes, and CFCX would have no net income for Country X purposes. Congress did not like this outcome and enacted the DCL rules. Applying the DCL rules, DREX's NOL is a DCL, and USP is not allowed a deduction with respect to the DCL unless an exception applies.

**Overview of the "Foreign Use" Rules.** Even though a loss qualifies as a DCL, a U.S. taxpayer can still be entitled to deduct a DCL provided that certain conditions are satisfied. In particular, a U.S. corporation (or consolidated group) is permitted to deduct the DCL: (a) if it can show there is no possibility of foreign use, or (b) by making a domestic use election ("DUE") (*See generally* Treas. Reg. §1.1503(d)-6(c), (d)). A DUE has to continue being made for future tax years and cannot continue to be made if there is foreign use of the DCL (*See* Treas. Reg. §1.1503(d)-6(e)). If a DUE cannot continue to be made, then the electing U.S. corporation (or U.S. consolidated group) is required to recapture the DCL as an income inclusion accompanied by an interest charge (*See* Treas. Reg. §1.1503(d)-6(h)).

Thus, for a taxpayer to deduct a DCL, it is critical that there not be any "foreign use" of the expenses/losses that gave rise to the DCL. Treas. Reg. §1.1503(d)-3(a)(1) provides that foreign use occurs "when any portion of a deduction or loss taken into account in computing the dual consolidated loss is made available under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws and that is, or would be, considered under U.S. tax principles to be an item of …a foreign corporation …." Moreover, the regulations provide that "[a] foreign use shall be deemed to occur in the year in which any portion of a deduction or loss taken into account in computing the dual consolidated loss is made available for an offset described in paragraph (a) of this section, regardless of whether it actually offsets or reduces any items of income or gain under the income tax laws of the foreign country in such year, and regardless of whether any of the items that may be so offset or reduced are regarded as income under U.S. tax principles" (*See* Treas. Reg. §1.1503(d)-3(b)). Thus, if "any" portion of a DCL is used to reduce the tax base of a foreign corporation under a country's "income tax laws," then there may have been use of that DCL, and the U.S. corporation is not allowed to deduct the expense.

It is important to note that, if there is foreign use of a DCL in a year after the U.S. taxpayer has made a DUE and deducted the DCL, the U.S. taxpayer is required to recapture the DCL as an income inclusion.

DCL Example 2: USP owns DREX and does not directly or indirectly own equity in any other Country X entity. In Year 1, on a separate entity basis, USP has $100 net income, and DREX has a net loss of $100. DREX's net loss of $100 is a DCL that, generally, may not be used to offset USP's $100 of income unless USP can show that there is no possibility that the DCL could ever have a foreign use. This is a famously difficult showing to make. For example, if USP could, in theory, acquire a Country X corporation and apply DREX's loss against the income of the acquired corporation, there is arguably a possibility of foreign use (*See* Treas. Reg. §1.1503(d)-6(a)(2)). Thus, if USP wants to use the DCL of DREX, USP must make a DUE. If USP makes a DUE for the DCL, and there is foreign use of the DCL in a later year, then USP would be subject to the DCL recapture provisions.

**Interaction of Pillar Two and the DCL Rules.** The advent of QDMTTs, IIRs, and UTPRs has given rise to numerous questions about whether there is foreign use of a DCL. The first issue is whether taxes under QDMTT, IIR, and UTPR regimes are "income tax laws of a foreign country" to which the DCL rules apply. Given that the Notice has indicated that QDMTTs and IIR taxes can potentially be foreign income taxes under Treas. Reg. §1.901-2 (*See* Notice §2.02(2)), taxpayers are understandably concerned that these Pillar Two taxes could also be part of the "income tax laws of a foreign country" for purposes of the DCL rules.

The second issue is whether the DCL rules were intended to apply to book-based taxes that are imposed on the aggregated income of related entities. The Notice provides no guidance on this issue but indicates that Treasury and the IRS continue to study whether and how the DCL rules should apply to Pillar Two taxes (*See* Notice §3.02).

The examples below frame some of the issues caused by applying the DCL rules to QDMTTs and IIR taxes.

DCL Example 3: USP owns DREX and CFCX. Country X generally does not permit loss sharing between DREX and CFCX, but Country X has adopted a QDMTT. Country X imposes a 5% income tax. In Year 1, on a separate entity basis, USP has $100 net income, CFCX has $100 of net income, and DREX has a net loss of $100. Country X imposes $5 of tax on CFCX and imposes no QDMTT on either DREX or CFC X because, under the QDMTT rules, the Country X income of the MNE Group is zero. The DCL rules completely disallow USP's loss (incurred through DREX). Because DREX's NOL was used to offset CFCX's income for the purpose of QDMTT, there was a foreign use of DREX's NOL. As a result USP cannot make a DUE.

While the facts and result of DCL Example 3 look similar to those of a traditional DCL fact pattern, such as DCL Example 1, the outcomes in the following DCL Examples 4 and 5 reflect how applying the DCL rules in a manner that takes into account the Pillar Two rules can yield inappropriate results. For the purpose of the examples below, assume that there is no difference between book and tax items.

DCL Example 4: USP owns DREX and CFCX. Country X generally does not permit loss sharing between DREX and CFCX, but Country X has adopted a QDMTT. Country X imposes a 15% income tax. In Year 1, on a separate entity basis, USP has $100 net income, CFCX has $100 of net income, and DREX has a net loss of $100. Country X imposes $15 of income tax on CFCX and imposes no QDMTT on either DREX or CFC X. Under the broad definition of "foreign use," arguably, there has been a foreign use of DREX's DCL under Treas. Reg. §1.1503(d)-3(a)(1) because it is taken into account to reduce the income of CFCX in computing QDMTT. Of course, the reduction in income provides no benefit, because the CFCX income is already subject to tax at the minimum rate of 15%, and DREX doesn't have any income to begin with. Thus, no top-up tax would be due even absent Pillar Two's aggregation of results on a jurisdictional basis.

DCL Example 5: USP owns DREX directly and owns CFCX indirectly through a Country Y CFC, CFCY. Country X has no QDMTT, but it has a 20% income tax rate. Country Y has an IIR. USP has $100 net income, CFCX has $100 of net income, DREX has a net loss of $100, and CFCY has no income or loss. Again, here, under the broad definition of "foreign use," there has arguably been a foreign use of DREX's DCL because it is taken into account, under Country Y's IIR, to reduce the income of CFCX in computing Country Y's IIR. In this instance as well, if the DCL rules in their current form are applied to IIRs, the result is a disallowance of DREX's DCL, even though, assuming taxable and Pillar Two income are largely the same on these facts, there is not now and never will be any foreign tax benefit arising with respect to the DCL precisely because there will never be a tax liability under Country Y's IIR given the Country X tax rate.

In both of the examples above, technically, there may be a foreign use of a DCL, but there is no foreign tax benefit in either situation because the foreign use of the DCL does not change the Pillar Two result. The Notice appears to recognize that outcomes like those in DCL Examples 4 and 5 are inappropriate (*See* Notice §3.02). The Notice also raises the issue that taxpayers are unable to elect out of loss sharing under the Pillar Two rules. For these reasons, the Notice provides that Treasury and the IRS are studying the extent to which the DCL rules should apply in relation to Pillar Two (*See* Notice §3.02).

In the meantime, the one item of guidance that the Notice provides is with respect to what it refers to as "legacy DCLs." The Notice defines a legacy DCL as a DCL "incurred in (i) taxable years ending on or before December 31, 2023, or (ii) provided the taxpayer's taxable year begins and ends on the same dates as the Fiscal Year of the MNE Group that could take into account as an expense any portion of a deduction or loss comprising such a DCL, taxable years beginning before January 1, 2024, and ending after December 31, 2023" (*See* Notice §3.03). Thus, for calendar year taxpayers, all DCLs incurred through calendar year 2023 are legacy DCLs. For fiscal year taxpayers, DCLs incurred in a taxpayer's fiscal year ending in 2024 are also legacy DCLs, assuming that the taxpayer's (U.S. corporation or consolidated group) tax year matches the tax year of its MNE Group for Pillar Two purposes.

The Notice provides a safe harbor for legacy DCLs pursuant to which there is no foreign use of a legacy DCL if the foreign use is solely because all or a portion of the deductions or losses that comprise the legacy DCL are taken into account under a country's Pillar Two rules (*See* Notice §3.03). Thus: (1) a U.S. corporation should be able to show no possibility of foreign use for a legacy DCL, when the only possibility of foreign use would be under a country’s Pillar Two rules, and (2) DUEs with respect to legacy DCLs should not be triggered if they are taken into account under a country’s Pillar Two rules.

The Notice also includes an exception to the safe harbor for “any DCL that was incurred or increased with a view to reducing the Jurisdictional Top-Up Tax or qualifying for the proposed rule described in this notice” (*See* Notice §3.03). Accordingly, to the extent taxpayers were prescient in creating DCLs in 2023 and before, which could carry forward into Pillar Two starting in 2024, Treasury and the IRS believe that these taxpayers should not get the benefit of the safe harbor and should instead suffer the application of the DCL rules in the context of Pillar Two to the extent that they will be applied to non-legacy DCLs.

The Notice’s treatment of DCLs and Pillar Two is unsurprising given the draconian nature of the DCL rules, but this treatment reminds taxpayers that QDMTT, IIR, and UTPR regimes present a new wave of opportunities for the DCL rules to preclude domestic use of valuable attributes.

## Conclusion

As we note at the outset, the Notice isn’t all bad. It acknowledges that QDMTTs may be creditable taxes, provides a limited safe harbor for the interaction of DCLs and Pillar Two, and extends relief from the final foreign tax credit regulations.

We suspect that most taxpayers will nevertheless think that the bad outweighs the good, given the Notice’s approach to IIR taxes and to DCLs generally. Despite assurances to the contrary, the Notice illustrates significant incompatibilities between Pillar Two and the U.S. federal regime for the taxation of international income and states further that Treasury and the IRS are studying issues Pillar Two brings to bear with respect to §245A(e) and §267A. In this regard, we close by noting that Treasury and the IRS have requested comments on the Notice until February 9, 2024. Given the novelty of Pillar Two, providing comments on the Notice and on any further guidance on the interaction of Pillar Two and the U.S. federal income tax regime seems entirely worthwhile.